(a) Integrate This Proceeding Into the New Local Interconnection Rulemaking. The comments support the view that the Commission should not act separately on LEC-CMRS interconnection issues, but should fold this proceeding into a single, comprehensive proceeding on local interconnection issues under Sections 251 and 252.[57] However, the Commission should move swiftly in taking this action because this proceeding is having the unintended effect of inhibiting the negotiation of new Type 2 contracts. Sections 251 and 252 specify that new contracts must contain mutual compensation arrangements unless the parties agree voluntarily to waive mutual recovery of costs.

Current Type 2 contracts between U S WEST's LEC and interconnected CMRS providers expire on December 31, 1996. Ordinarily, the parties would already be negotiating the terms and conditions of new contracts; in fact, negotiations are just beginning and meaningful negotiations will be difficult until this proceeding is terminated.

This proceeding has created considerable uncertainty within the industry. Will this Commission preempt the state commissions? Will it adopt "bill and keep" or other new rules on the pricing of LEC-CMRS interconnection? Until these issues are addressed, neither LECs nor CMRS providers can engage in meaningful and productive negotiations over new interconnection contracts.

[57] *See, e.g.*, Comments of Alaska Telephone Ass'n at 1-2; Alaska Telephone Utility at 1-2; ALLTEL at 6-7; Anchorage Telephone Utility at 9; Bell Atlantic at 14-16; Bell Atlantic NYNEX Mobile at 7-8; Cincinnati Bell at 7-8; Frontier at 5-6; GTE at 28-29; Home Telephone at 2; NECA at 2-3; NTCA at 7; New York Department of Public Service at 2; NYNEX at 3-5; Pacific Telesis at 3-4; Public Utilities Commission of Ohio at 9-10; Smithville Telephone at 6; John Staurulakis at 7; and SBC Corporation at 4.

(b) Access Reform. The Commission has already announced that it will commence "in the near future" a new proceeding examining reform of the current access charge regime.[58] As the comments filed by interexchange carriers attest, this proceeding is very important and, as the Commission has noted, the issues of local interconnection and access "are closely related."[59] Given the convergence of the industry, including the fact that interexchange carriers will soon be providing both interexchange and exchange services (landline and wireless), it is essential that the Commission address local interconnection and access reform in tandem.

(c) Rates for Local Residential Service. As discussed above, real reform in interconnection and access pricing cannot occur until rates for local residential service cover the costs of providing that service. Consequently, this Commission should also commence a proceeding examining the impact of below-cost local rates on the local interconnection and access markets.

VIII. Conclusion

The pleas of certain CMRS providers for immediate Commission action ring hollow, given that they enjoy "a highly profitable business" with the current interconnection arrangements they negotiated, and given that this Commission must complete a new proceeding for all local interconnectors by August 9, 1996.

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[58] Notice at 9 ¶ 17.

[59] Id. at 37 ¶ 77.

Also lacking merit is the assertion that Commission intervention is needed to offset disparate bargaining power in negotiation.[60] The CMRS providers making this argument ignore that the highest interconnection rates are generally imposed by the smallest LECs, not the large LECs.[61] They ignore the recent Congressional determination that state commissions should be responsible for intervening in local interconnection disputes involving all interconnectors.

CMRS providers are too late in arguing that they cannot rely on interconnection contracts to achieve desirable results. In enacting the 1996 Act, Congress was aware of the 10-year history of LEC-CMRS negotiated interconnection agreements and, fully cognizant of this track record, it chose a contract regime as the permanent solution for local interconnection matters, including interconnection between LECs and CMRS providers.

As noted, the industry has not yet had an opportunity to implement Congress' new model for local interconnection. In these circumstances, it would be imprudent for this Commission to order some local carriers to use an interconnection model different from

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[60] The Internet model confirms that, in fully competitive markets, there will be differences in bargaining power between carriers of different sizes (because smaller carriers generally receive more value from interconnection than *vice versa). See* U S WEST Comments, Attachment B. *See also* note 42 *supra* and accompanying text. Three points are significant. First, as one would expect in a competitive market, LEC-CMRS interconnection charges have been decreasing as CMRS providers have increased their customer bases. Second, the non-discrimination requirement protects small CMRS providers; they are generally entitled to the "same deal" negotiated by their larger competitors (like AT&T and Sprint/TCI). Third, CMRS providers remain "a highly profitable business."

[61] Even if larger LECs did have more bargaining strength compared to CMRS providers, this does not mean CMRS providers, with their fast growing customer bases, have no bargaining power. *See* U S WEST Comments at 66-67.

the new model. And, it would certainly be imprudent for this Commission to adopt an interconnection compensation policy that is flatly inconsistent with the compensation policy adopted by Congress.

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March 25, 1996

ATTACHMENT

U S WEST Reply Comments
CC Docket No. 95-185
March 25, 1996

Cost-Recovery and CMRS Interconnection
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This paper has three sections which explain why local exchange carriers (LECs) should be allowed to recover incremental, common, and legacy costs in their interconnection charges with commercial mobile radio (CMRS) providers. Section A outlines the fundamental differences between LECs and CMRS carriers. Section B provides a set of economic principles to be used for interconnection pricing policy. Finally, section C explains why the Commission should maintain, as an interim policy, the existing interconnection agreements between LECs and CMRS carriers and drop its bill and keep proposal.

A. FUNDAMENTAL DIFFERENCES BETWEEN LECS AND CMRS PROVIDERS SHOULD BE CONSIDERED IN ESTABLISHING INTERCONNECTION CHARGES

When establishing interconnection polices for LECs and CMRS providers, the following three **fundamental differences** between the two types of carriers make it critically important for regulators to permit prices that compensate LECs for the incremental, joint and common, legacy, and universal service costs of LECs networks:

First, carrier of last resort and universal service obligations require LECs to serve every customer in their franchise areas who requests it, at geographically averaged rates, with government-imposed upward limitations on the prices LECs can charge. CMRS providers only serve customers when its profitable to do so (i.e. the expected revenues are higher than costs of serving a customer). Moreover, CMRS providers benefit enormously from the LECs service obligations, because the value of CMRS service – and therefore the price customers are willing to pay – is substantially greater due to the ubiquity of LECs' publicly switched telephone networks (PSTN) networks.

Second, the monthly price of the LEC-provided residential local access is held below cost by state laws and regulatory agencies and is cross-subsidized by other services and functions. CMRS providers are never forced, by government policy to provide services below cost. CMRS providers have no such regulatory pricing restrictions and can therefore recover the full cost of their "local loops" and the other costs of providing network access through the monthly subscriber charges they levy on their customers. The primary reason that access charges for interexchange carriers (the equivalent of interconnection charges) are set above cost is to subsidize the price of the LECs' local access. LEC-CMRS interconnection charges have also historically provided part of this subsidy. The Cellular Telecommunications Industry Association estimated that CMRS carriers paid $800 million in 1995 to LECs for interconnection.[1] LECs book this as intrastate revenue. If this *state* revenue is reduced because of a *federal* imposition of bill and keep, LECs such as U S WEST Communications (U S WEST) will be put in the difficult position of having to get permission from their *state* regulators to raise rates in order to make up for a *federal* policy change.

Third, broadband CMRS providers charge their customers approximately $.40 per minute for usage but LECs are prohibited in many states from charging anything for local usage, effectively requiring LECs to give local usage away for free. For example, when a LEC subscriber calls (or is called by) a local CMRS subscriber the LEC does not receive any incremental revenue for that call but the CMRS provider receives a usage charge

[1] CTIA, Fact Sheet Reciprocal Termination (accompanying a Dec. 15, 1995 press release). The USTA estimate total CMRS interconnection payments to be $1.1 billion. See Rohlfs, Shooshan, Monson, *Bill-and-Keep: A Bad Solution to a Non-Problem*, March 4, 1996.

of approximately 40¢ per minute. Moreover, even when LEC customers do pay for usage, they pay only for originating calls, while CMRS carriers typically charge their customers both for terminating and originating minutes of use. Clearly CMRS providers can afford to make a contribution to the common and legacy costs and universal service obligations they benefit from so heavily.

Collectively the differences between LECs and CMRS providers imply that local interconnection policy should enable LECs to recover the incremental costs associated with interconnection as well as some portion of the joint, common, legacy and universal service costs of the network through interconnection prices as described below.

B. PRICING PRINCIPLES FOR ESTABLISHING INTERCONNECTION AGREEMENTS

Interconnection prices should be established on the basis of economic pricing principles. Pricing principles refer to the standards or criteria which should be used in setting or evaluating the prices of goods or services. There are three economic pricing principles of fundamental importance:

First, negotiations between private parties, in the context of broad guidelines set by the regulators to prevent anticompetitive behavior, are the most appropriate way to actually establish prices for the sale of interconnection services. Second, the price of each service should be based on the cost of providing that service. Long-run incremental cost (LRIC or TSLRIC which is defined below) should be used as a cost floor to protect against prize squeezes or cross-subsidies to competitive services. Hence, if this Commission requires LECs to price interconnection (or any other service purchased by competitors) below its incremental cost, as would be the case with a bill and keep regime, LECs would be forced to subsidize competitors with below-cost prices. This type of mandatory below cost pricing would be an taking of LECs property and could force LECs such as U S WEST into financial distress, undermining investment in the PSTN.

Third, cost-based pricing also dictates that prices recover common costs when, due to scale or scope economies, there are substantial shared and common costs that are not included with the LRIC of any individual service. Hence, cost-based pricing does NOT mean prices equal costs because prices should include a markup above the incremental cost. Therefore, prices should take account of the conditions of demand for a particular service (i.e., rates should be market-based as well as cost-based). This principle implies that as demand conditions change over time due to competition, technological innovation, or changing customer preferences, the markups of prices over costs should also change. Markup pricing is widely practiced in competitive markets because all firms must price to recover their shared and common costs, which they do by marking up prices above LRIC. If firms did not price some of their services above incremental costs, they would not cover their common costs. Hence, in industries with common costs, competition does NOT drive prices to LRIC.

Establishing the proper relationship between a LEC's costs and prices for interconnection services requires the consideration of three categories of costs in the price setting process: total service long run incremental cost ("TSLRIC"), joint and common costs, and legacy costs that have accumulated as part of historical and ongoing regulatory requirements, such as rules which maintain regulated depreciation lives in excess of economic lives.

TSLRIC should be defined as the forward-looking cost avoided (or added) by discontinuing (or offering) an *entire* service or group of services, holding constant the production of all other services produced by the firm. The forward-looking aspect of TSLRIC contains the assumption that the entire service or group of services will be produced with maximum technological efficiency. However, it should be noted that even in a competitive industry with no economies of scale or scope, firms do not price at TSLRIC. Setting prices equal to the incremental cost of the most efficient forward-looking producer of a service or product could drive all other producers from the market, and even cause a multi-location producer to close all but its most efficient production location. In all industries, there are efficiency differences among firms arising from a combination of geographic, capital and managerial factors. Rather than price to the most efficient producer's incremental cost, the basic economic fact that firms must cover all of their costs, will drive prices toward the costs of the least efficient viable competitor or production location.

Common costs are an important factor in setting prices. In many industries, including network industries, there are substantial economies of scale and scope that significantly improve production efficiency. The underlying infrastructure -- such as conduit and poles and operating systems, and the technical and managerial human capital that is shared among many different services -- are sources of scale economies in the provision of telecommunications services. Not all of these costs are included in the calculation of specific incremental costs. That is, the sum of the TSLRICs for all services is considerably less than the total of U S WEST's costs to provide telecommunications services in the most efficient manner (i.e., by sharing infrastructure and resources across services). All firms, not only regulated firms, either price to cover all of their costs, or they cease to exist.

A LEC is also entitled to recover its legacy costs that have accumulated as part of the regulatory compact. For example, U S WEST operates under rate of return regulation in all of its franchise states. This regulation is a social and legal contract between U S WEST and the states it serves. Under these contracts, U S WEST has the duty to provide ubiquitous telephone service, at affordable prices, to all customers in its service territory. To meet its obligations, LECs have made, and will continue to make, substantial capital investments in their service areas. In return, state and federal regulators commit to giving LECs the opportunity to recover their capital and earn a fair return on investment. Depreciation rates set in the regulatory process, in part to serve long-term social policy goals, are central to the fulfillment of the contract. If this process results in depreciation lives in excess of the economic lives (based on the best estimate of engineering and technological lives of the different classes of plant), stranded plant is an expected result. Regulators have consistently required that U S WEST use longer asset lives than U S WEST would have chosen for itself, and are therefore obligated to allow U S WEST to recover any resulting stranded investment.

It is important to emphasize that interconnection prices should not be exempt from paying a share of common, joint and embedded costs. Otherwise, competitors could free ride on a LEC's investments and avoid paying for network elements from which they benefit.

C. CONTINUATION OF CURRENT AGREEMENTS IS THE BEST INTERIM INTERCONNECTION POLICY

Allowing LECs to continue using existing interconnection agreements with CMRS providers is the best interim policy until a broader access and interconnection reform proceeding takes place. Powerful wireless competitors are fully capable of negotiating effective interconnection agreements with the incumbent LEC. In U S WEST's service territory, AT&T Wireless, Sprint Spectrum, Bell Atlantic Metro Mobile, and Western Wireless/PCS are all large carriers and have negotiated effective interconnection agreements with U S WEST.

In 1995, U S WEST estimated that it received $70 million or $0.49 per residential customer per month in CMRS interconnection fees. If this intrastate revenue is eliminated by the federal imposition of a bill and keep policy, U S WEST will have to recover this money from another source. The elimination of intrastate revenue by federal regulators without providing some compensating adjustment is patently unfair.

U S WEST's average CMRS interconnection rates are approximately 2.2 cents per MOU. If the TSLRIC of interconnection is conservatively assumed to be half this amount (1.1 cents per MOU) than a bill and keep policy would amount to a $35 million subsidy from U S WEST's intrastate ratepayers to CMRS providers and subscribers. Cross-subsidies are rarely meritous, but bill and keep would violate the most basic principle of cross-subsidization -- that high value added, premium services (such as CMRS) should contribute to the support of essential services such as access to the local network. Given the positive correlation between household income and cellular telephone use, imposing bill and keep for LEC-CMRS interconnection, is a form of regressive taxation. Clearly this unintended consequence was not the Commission's objective in proposing bill and keep. Hence, the Commission should refrain from establishing such a poorly conceived, economically irrational and regressive "interim" policy and follow the guidelines in the recent federal legislation by allowing CMRS providers to continue to negotiate interconnection agreements with LECs, including the prices each pays the other for terminating its traffic.

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 25th day of March, 1996, I have caused a copy of the foregoing **REPLY COMMENTS OF U S WEST, INC.** to be served via first-class United States Mail, postage prepaid, upon the persons listed on the attached service list.

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